Effective: March 25, 1994

COORDINATED ISSUE
SECURITIES & FINANCIAL SERVICES INDUSTRY
CAPITALIZATION OF COSTS TO OBTAIN MANAGEMENT CONTRACTS

ISSUE:

Whether costs incurred by investment advisors to obtain management contracts by creating new mutual funds are currently deductible under section 162(a) of the Internal Revenue Code, or are required to be capitalized under section 263(a).

CONCLUSION:

Costs incurred by investment advisors to create new mutual funds and thereby obtain management contracts are required to be capitalized under section 263(a) of the Code.

FACTS:

From time to time, investment advisors that already are managing mutual funds create new mutual funds. The investment advisors incur substantial internal and external costs to create new funds. These costs typically include expenditures for investment and market research, legal and accounting fees, regulatory costs, and other outlays to organize mutual funds and bring them to market. After the new mutual fund is formed, it sometimes reimburses the investment advisor for some of these costs. Only those costs that are incurred before the management contract is entered into and are not reimbursed are at issue in this paper.

At the time of the fund's formation, its sole shareholder generally is an affiliate of the investment advisor. Typically, up to sixty percent of the fund's board of directors are employees or otherwise are associated with the investment advisor or one of its affiliates. Because the fund itself has no employees, it enters into contracts with the investment advisor, a distributor, and sometimes an administrator.[1] Each entity with which the mutual fund contracts is paid an annual fee based upon an agreed-upon percentage of the annual net assets of the fund. The agreed-upon percentage is subject to certain regulatory limitations. In many cases, the distribution contract and the administrative services contract are entered into with members of the investment

[1]Sometimes the investment advisor also acts as fund administrator.

advisor's consolidated group.

The contract between the investment advisor and the fund (the management contract) determines the advisor's responsibilities with respect to the management of fund assets. It also specifies the compensation to which the advisor is entitled, which ordinarily varies from .5 percent to .75 percent of the average net assets of the fund each year.

An investment advisor risks its capital on the formation of a new mutual fund because, as the founder of the fund, the investment advisor expects to be awarded the fund's initial management contract and to have that contract periodically renewed. Although the terms of a management contract and any renewal thereof must be approved by a majority vote of the fund's independent directors, it is extremely rare for a management contract to be terminated or not to be renewed. Thus, management contracts with an investment advisor generally remain in force as long as a particular fund remains in operation. If, however, a particular fund fails in its early years, the contract terminates and the advisor suffers an economic loss. The customer relationships reflected in the management contracts are major elements of the value of an investment advisor's business.

LAW AND ANALYSIS:

Requirement to capitalize

Section 162(a) of the Code allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. The term "necessary" imposes the requirement that the expense be appropriate and helpful to the development of the taxpayer's business. The term "ordinary" clarifies the distinction between currently deductible expenses and capital expenditures. Welch v. Helvering, 290 U.S. 111 (1933); Commissioner v. Tellier, 383 U.S. 687 (1966).

Section 263(a) of the Code provides that no deduction is allowed for any amount paid out for permanent improvements or betterments made to increase the value of any property.

In INDOPCO, Inc. v. Commissioner, ___ U.S. ___, 112 S. Ct. 1039 (1992), the Supreme Court concluded that certain legal and professional fees incurred by a target corporation to facilitate a friendly acquisition were capital expenditures. The Court stated that the acquisition costs created significant long-term benefits for the taxpayer. In reaching this decision, the Court specifically rejected the argument that its decision in Commissioner v. Lincoln Savings & Loan Association, 403 U.S. 345 (1971), should be read as holding "that only expenditures that create or enhance separate and distinct assets are to be capitalized under section 263." 112 S. Ct. at 1044 (emphasis in original).

In the present case, the investment advisor makes expenditures that result in the creation of a mutual fund. As the fund's founder, the advisor expects to be awarded the initial contract to manage the new fund, as well as the annual renewals of that contract for so long as the fund exists. The contract embodies the investment advisor's management relationship with the new fund, i.e., the right to provide fund management services in exchange for remuneration. Both the investment advisor and the fund realistically expect the relationship to continue indefinitely. The relationship therefore is a separate and distinct asset with an expected life of more than one year. See Rodeway Inns of America v. Commissioner, 63 T.C. 414 (1974), acq. 1975-1 C.B. 2 (payment to acquire right to conduct business from which taxpayer could anticipate future profit was a capital expenditure); See also Darlington-Hartsville Coca-Cola Bot. Co. v. United States, 393 F.2d 494 (4th Cir. 1968), cert. denied 393 U.S. 962 (1968) (expenditures to eliminate unproductive middleman and thus obtain contracts for raw materials directly from supplier are required to be capitalized because the contracts improve profits in future years).

In general, the costs incurred to create or enhance an asset must be capitalized under section 263(a) of the Code. See Commissioner v. Lincoln Savings & Loan Association, 403 U.S. 345 (1971); § 1.263(a)-2 of the Income Tax Regulations. Although the fund itself is not an asset of the investment advisor, establishment of the fund is a necessary step in order to acquire the contractual right to earn income indefinitely by managing the fund. Because that right, or relationship, is an asset, the investment advisor is required to capitalize the costs it incurs in establishing the new mutual fund.

Even if that relationship were not a separate and distinct asset, INDOPCO still would require an investment advisor to capitalize expenditures incurred to create the new mutual fund.[2] The existence of the fund is a significant long-term benefit to the investment advisor because the advisor expects to realize significant economic benefits from long-term contractual relationships with the fund. In fact, since the costs at issue

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[2]The Supreme Court granted certiorari in INDOPCO to resolve a perceived conflict among the circuits concerning the requirement to capitalize expenditures that do not create separate and distinct assets but nevertheless result in significant long-term benefits. In holding that the taxpayer in INDOPCO was required to capitalize fees incurred to facilitate a friendly acquisition, the Court specifically rejected the analysis of cases such as NCNB Corp. v. U.S., 684 F.2d 285 (4th Cir. 1982) (en banc), and Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775 (2d Cir. 1973), to the extent they suggested that a separate and distinct asset was a prerequisite to capitalization under section 263(a).

include only those incurred before the fund is in operation and the contract is in place, the benefits they produce are predominantly future benefits.

Entitlement to amortize amounts that are capitalized

Code section 167 provides a depreciation or amortization deduction for the exhaustion of property used in a trade or business or held for the production of income. In order to be eligible for amortization under section 167, an intangible asset or benefit must have a limited useful life the length of which can be estimated with reasonable accuracy. See § 1.167(a)-2 of the regulations; Newark Morning Ledger v. U.S., ___ U.S. ___, 113 S. Ct. 1670 (1993). Thus, the capitalized costs of creating a new mutual fund may be amortized only if the useful life of the relationship with the fund can be determined, based on historical or industry-wide information.